NATURAL GAS IMPACT ON STATE AGENCIES

A Report Prepared for the

Legislative Finance Committee

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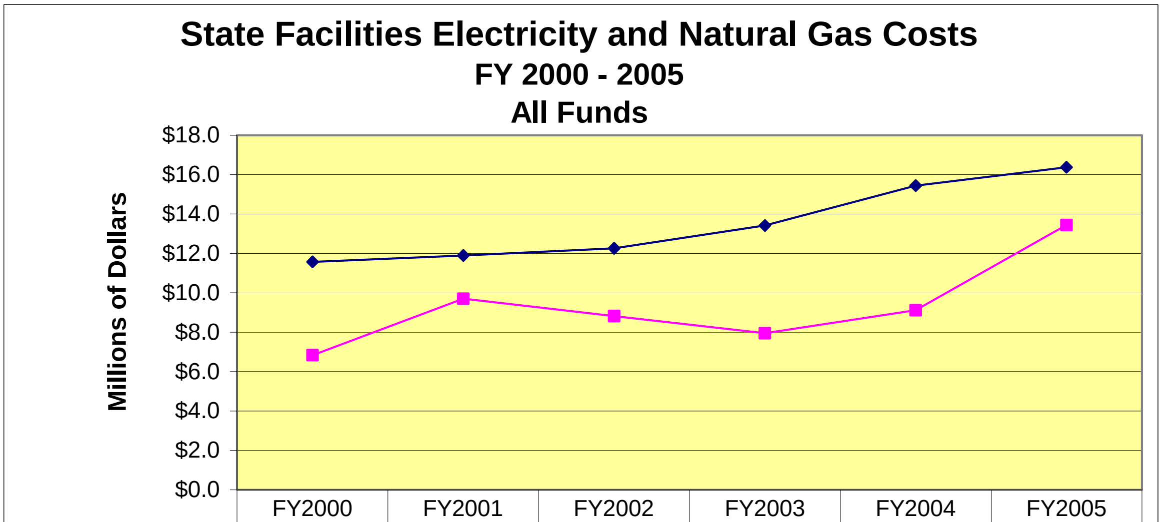
www.leg.state.mt.us/css/fiscal/

PURPOSE

The purpose of this paper is to provide a background for committee discussion of initial trends in natural gas prices and the ramifications on state agency expenditures. It is meant as an initial informational report for use as a prelude to additional updates throughout the interim.

BACKGROUND

The State of Montana owns or leases a large number of buildings around the state. As of 2004, the state owned 1,893 buildings with a value greater than $50,000, including 819 buildings in the Montana University System and 436 in the Department of Transportation.[1] Heating and cooling these buildings is consequently a major expense of the state. The following shows the total spent on natural gas and electricity by the state since FY 2000. As shown, natural gas costs were $9.1 million in FY 2004 and $13.4 million in FY 2005.



	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Electricity	11575804	11902417	12261237	13413670	15447055	16377360
Natural Gas	6837129	9706041	8818640	7950571	9121905	13437815

Due to the recent volatility of natural gas, this portion of the report focuses only on that commodity. Updates on electrical costs will be provided as warranted throughout the interim.

[1] The total number of buildings, including storage sheds and outhouses, is almost 4,700. Source: Commercial Property Schedule, Department of Administration.

How is Natural Gas Priced

Natural gas prices are the sum of three main components: 1) commodity price; 2) transmission cost; and 3) distribution costs. Distribution and transmission costs are regulated by the Public Service Commission (PSC) and are both more stable and reviewed less often. The increase in cost of natural gas is overwhelmingly being caused by increases in the actual commodity price. Commodity prices are both reviewed and established by the PSC, but not regulated. Instead, the PSC ensures that the amount charged for the commodity by the utility does not exceed the cost paid. Consequently, commodity price is driven by national and regional market factors. In Montana, the cost of the commodity as a percentage of the total bill was about 70 percent for residential consumers on July 1, 2005, according to Northwestern Energy.[2] However, as the price of the commodity increases, this percentage will also rise.

Because the actual commodity price is the volatile portion of the cost to state agencies, the remainder of this paper focuses exclusively on commodity price.

The Current Natural Gas Market

Natural gas prices have been averaging significantly higher for several months, and have more recently spiked due to the effects of hurricanes Rita and Katrina, exacerbating the already higher costs. Prior to Hurricane Rita, the Department of Energy predicted an average price of natural gas per thousand cubic feet (MCF) at $8.82 for 2005 and $8.42 for CY 2006.[3] However, natural gas prices on the major national exchanges have averaged significantly higher, in part because of a higher than anticipated impact of Hurricane Rita[4]. Global Insights, the company with which the legislature contracts for financial information, warns that consumer prices will increase 50 percent this winter, with major natural gas exchange prices for the November to March time period as of September 28 topping $12 per dekatherm, compared with $5 to $6 per dekatherm last year. The Natural Gas Exchange in Calgary is a more relevant indicator of prices in Montana, as a large portion of natural gas purchased for consumption in the state is from Alberta. This exchange traditionally averages slightly lower than the other major exchanges and was $11.36 on October 3.[5]

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[2] Source: Northwesternenergy.com. Transmission and distribution costs are a lower percentage of the total residential energy bill nationwide, where the average is about 50 percent of costs.
[3] Phone conversation with Jeff Blend of DEQ on October 3, based upon the EIA Short-term Energy Outlook, September 7, 2005.
[4] US Department of Energy.
[5] Phone conversation with Dan Hickman, Jefferson Energy, on October 3. The winter spot price on that day was about $12.31.

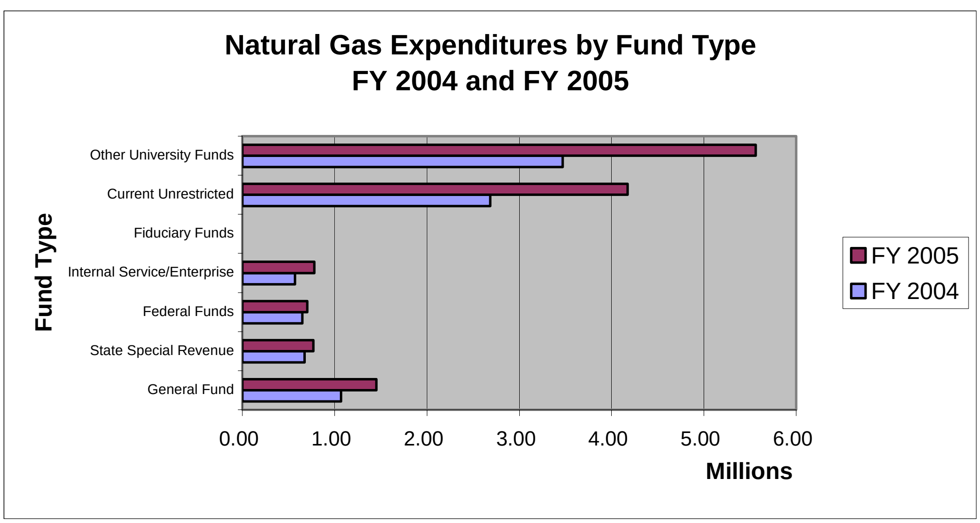
IMPACT ON STATE AGENCY EXPENDITURES

The following shows expenditures for natural gas by agency in FY 2004 and FY 2005.

Expenditures for Natural Gas
FY 2004 and FY 2005

Agency	FY 2004	Percent of Total	FY 2005	Percent Increase
Montana University System	$6,155,661	67.5%	$9,734,677	58.1%
Military Affairs	670,098	7.3%	728,582	8.7%
Corrections	522,266	5.7%	815,076	56.1%
Public Health and Human Services	515,010	5.6%	696,844	35.3%
Tranportation	453,263	5.0%	458,537	1.2%
Administration	423,534	4.6%	585,974	38.4%
FWP	126,023	1.4%	110,019	-12.7%
Justice	56,601	0.6%	64,214	13.5%
School for the Deaf and Blind	53,272	0.6%	62,298	16.9%
Labor and Industry	47,710	0.5%	56,629	18.7%
Revenue	34,198	0.4%	38,746	13.3%
DNRC	29,327	0.3%	42,215	43.9%
State Fund	17,407	0.2%	18,499	6.3%
Livestock	12,563	0.1%	20,671	64.5%
Agriculture	3,779	0.0%	4,058	7.4%
Commerce	844	0.0%	275	-67.4%
DEQ	223	0.0%	379	70.0%
Judiciary	128	0.0%	130	1.6%
Total	$9,121,907		$13,437,823	47.3%

As shown, over two-thirds of all natural gas expenditures are made by the Montana University System. The following shows natural gas expenditures by fund type. Current unrestricted and all other university funds reflect the natural gas expenditures of the university system. Approximately 40 percent of current unrestricted expenditures are from the general fund, with the bulk of the remainder from tuition. Other university funds are from a variety of sources, including various fees and federal funds.



There are two primary questions concerning the impact of the volatility of the natural gas commodity on state agency budgets:

1) How susceptible are state agencies to the changes in commodity cost?
2) What budget actions were taken by the legislature in anticipation of future costs?

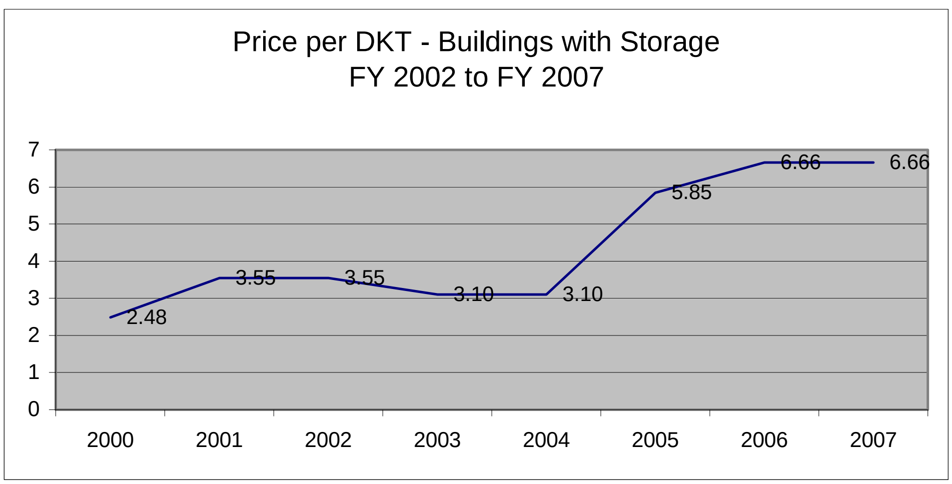
SUSCEPTIBILITY OF STATE AGENCIES TO CHANGES IN COMMODITY PRICE

As stated, the actual cost of the commodity is subject to market forces. However, different state buildings are subject to different realities as to that cost, depending upon whether they are part of the state's natural gas supply contract or not.

Contract

The largest users of natural gas are part of a contract negotiated by the Department of Administration with suppliers. The current contract is with a company called Jefferson Energy (Jetco) and is for the entire 2007 biennium. Through this contract, the state is guaranteed a price per dekatherm, as well as a supply of natural gas at the negotiated price.[6] The contract with Jetco does not cover the transmission and distribution charges billed by Northwestern and regulated by the PSC, although Jetco passes those charges through on its own invoices.

The following shows the contract cost for FY 2004, FY 2005, and the 2007 biennium. As shown, the contract price was significantly increased in FY 2005, explaining much of the increase in costs between FY 2004 and FY 2005.



Source: Department of Administration

Straight Meter Charge

The natural gas costs of the remainder of state-owned agency buildings are whatever the supplier in that particular area is charging for gas.

The following shows the facilities on the Jetco contract. The table also provides a sample of the buildings not on the contract. Please note that the sample is not a complete list.

[6] According to Dan Hickman of Jetco, the company assumes all risks of the volume of energy use. For example, if the winter is harsher than anticipated and initially presumed usage is up, the state is still entitled to natural gas at the negotiated price.

Buildings on and Off the State Contract
2007 Biennium

On Contract	Off Contract - Sample, only
Within Helena	
Capitol and Capitol Annex	Military Affairs
Old Livestock (General Services Division)	OPI
Mitchell (Administration and Revenue)	Corrections
Historical Society	Commerce
Cogswell (DPHHS)	Main DNRC Building
Transportation	MSU - Billings
FWP (main building)	Pine Hills School
DPHHS	State Fund Building
Metcalf (DEQ)	Law Enforcement Academy
New Justice/State Library	Other MDT buildings
Scott Hart (Agriculture and Livestock)	
Walt Sullivan (Labor and Industry)	
Out of Helena	
Montana State Hospital - Warm Springs	
Montana State Prison - Deer Lodge	
Montana Developmental Center - Boulder	
Montana Veterans Home - Columbia Falls	
Montana Mental Health Nursing - Lewistown	
Montana University System	
MSU	
MSU - Northern	
MSU - Bob Miller Pavilion	
MSU - Marsh Lab	
MSU Firm Gas Meter	
MSU Family Student Housing	
UM	
UM - Montana Tech	
UM - Western	
UM Scisson Criaghead Apartments	

Percentage of Costs on the Contract

As shown in the earlier table, the Montana University System is the most significant user of natural gas in state government. According to representatives from both MSU and UM, they do not have specific figures as to how much of the total expenditures are part of the contract. However, MSU estimates that 95 to 96 percent of the total main campus charges are part of the contract[7]. MSU-Northern in Havre is also on the contract, as are some costs of the Agricultural Experiment Stations and the Extension Service. The Great Falls College of Technology gets its gas supply from Energy West.

MSU-Billings was on the contract in FY 2005, but are not part of the current contract. As of this writing they have not negotiated a replacement contract, and consequently could be facing a significant increase in natural gas costs. In FY 2005, the college expended over $575,000 from all sources.

[7] Phone conversation with Patti Yasbek on October 4, 2005.

At the University of Montana, all of the campuses except the two colleges of technology in Missoula and Helena are part of the contract. These two units comprise about 10 to 12 percent of the cost. Smaller units such as Yellow Bay are also not on the contract, and in total are approximately another 1 percent of the total.[8]

For the remainder of state government, approximately one-half of the total natural gas usage, which totaled $3.7 million in FY 2005, is for buildings on the state contract.

Rent Through Department of Administration

Not all agencies pay natural gas costs directly. Agencies may be either directly responsible for the cost of the gas they consume, or they may pay a set charge to the Department of Administration through rent.

The buildings in what is known as the "capitol complex" in Helena as well as some other buildings within the city are all charged a monthly per square foot rental charge by the Department of Administration, which includes utilities. This rental charge is approved by the legislature and cannot be raised above the ceiling level established by the legislature. Therefore, the department must include an appropriate level of rental charge to cover utilities for the two years of the biennium. Because these rates are generally established well in advance of the legislative session, the department is essentially forecasting up to three years into the future. All risk is assumed by the Department of Administration for unanticipated usage and price. The Department of Administration calculates the rental charge by examining all components of the cost of upkeep of the buildings, including personal services costs. In FY 2004, natural gas was about 6 percent of the total cost of rent.

The danger to the state of higher than anticipated rates and/or usage is therefore that the rental income will be insufficient to cover the costs. In that event:

1) Agencies must either reduce consumption; or
2) The department must seek additional funding from the legislature

Among the buildings for which rent is paid but are not on the Jetco contract are commerce, OPI, and corrections. The total natural gas expenditures for all buildings that pay rent but are not on the contract were just over $87,000 in FY 2005[9].

Total rental income collected in FY 2004 from both office and warehouse space, as well as miscellaneous other revenue, was $5.9 million. Collections are budgeted at $6.9 million in both FY 2006 and FY 2007. The total budget for facilities and maintenance in FY 2006 is $8.2 million.

Leased Buildings

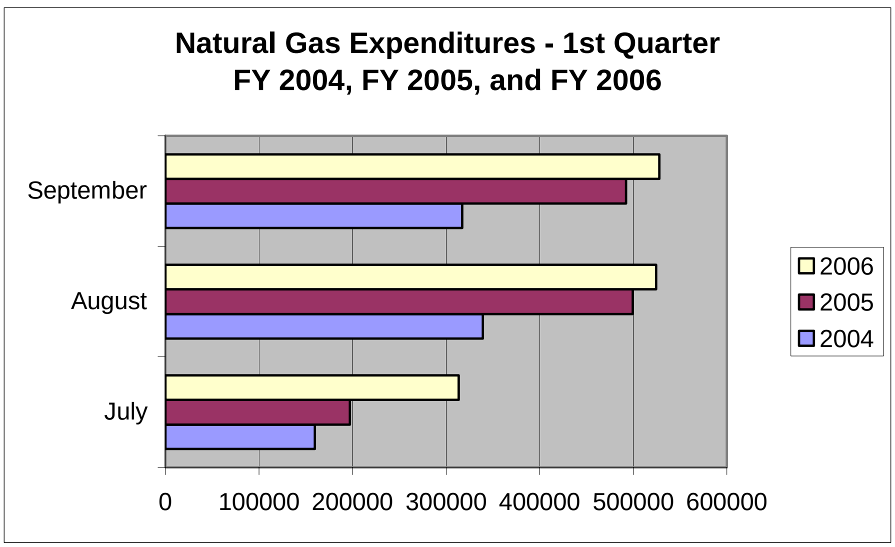
In addition to all of the state owned buildings, various state agencies lease buildings all around the state. The state leases over 250 sites. According to Garett Bacon of the Department of Administration, most leases include utilities in the cost, and the lease includes a cost inflator (generally either 2 or 3 percent) that includes any increases in utilities. Therefore, the lessor assumes all risk for significant utility cost increases within the lease period.

[8] Phone conversation with Laura Howe, University of Montana, October 5, 2005.
[9] Source: General Services Division, Department of Administration monthly utilities report.

The lease lengths vary from a month-to-month basis to over 10 years. In the 2007 biennium, 66 leases will expire, with a further 57 expiring on June 30, 2007[10]. Those leases will have to be renegotiated and will likely increase due to utility cost increases.

THE 2007 BIENNIUM

The coming months will obviously be critical in determining whether agencies will be able to fund natural gas costs without either major operational disruption and/or supplemental appropriations. However, regardless of winter severity, state government will expend significantly more for natural gas in FY 2006 than in FY 2004 due to commodity price increases over the base year. The 2005 legislature provided an 18 percent increase in total natural gas costs from FY 2004 to FY 2006, with a 12 percent increase from FY 2004 to FY 2007. Rental costs were increased to reflect a similar increase in natural gas expenditures. In addition, at its May meeting the Board of Regents of the Montana University System voted to authorize a natural gas surcharge[11]. However, costs are currently trending higher than the inflated level funded by the legislature. The following shows expenditures through the first quarter in FY 2004, FY 2005, and FY 2006.



Staff will continue to monitor this issue as the winter season unfolds and provide updates to the Legislative Finance Committee.

[10] Statewide lease summary by city, Department of Administration.

[11] $0.35 per credit hour at the University of Montana and $0.90 per credit hour at Montana State University. The surcharge is expected to raise $472,000 each year.